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Supreme Court of the United States

OCTOBER TERM, 1948.

No. 731

HUGH SMITH, INC., PETITIONER,

VS.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

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INDEX

Opinion Below 2

Basis of Jurisdiction 2

Questions Presented—

I. Does Section 45 of the Internal Revenue Code authorize the Commissioner to "allocate," except to prevent evasion of taxes or clearly to reflect income 2

II. If the petitioner had in fact received income from the purchase and re-sale of Coca-Cola syrup would it have been personal holding company income, as defined in Section 502 of the Code 2

Summary Statement of Facts 3

Reasons for Granting the Petition 7

CITATIONS

Hugh Smith, Inc., 8 T. C. 660 ..... 2, 10

Section 45, Internal Revenue Code 2, 4, 7, 9, 10

Section 502, Internal Revenue Code 2, 9, 10

Section 500, Internal Revenue Code 4

Sen. Rept. No. 960, 70th Cong., 1st Sess., p. 24 and H. R. Rept. No. 2, 70th Cong., 1st Sess., p. 16 8

Title 28, U. S. C., Section 1254(1) 2

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COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner prays that a writ of certiorari issue to review the order of judgment of the United States Court of Appeals for the Sixth Circuit in this cause, which was entered (without opinion) on February 1, 1949, and which affirmed the decision of The Tax Court of the United States, entered on June 25, 1947.

OPINION BELOW.

The Court of Appeals did not file an opinion. The findings of fact and opinion of the Tax Court are reported in 8 T. C. 660.

BASIS OF JURISDICTION.

Jurisdiction is invoked under Title 28, United States Code, Section 1254(1).

QUESTIONS PRESENTED.

I.

Does Section 45 of the Internal Revenue Code (the purpose of which was "to prevent evasion of taxes or clearly to reflect the income") authorize the Commissioner to "allocate" to petitioner, or to any taxpayer, income which it is known never to have earned or received, and when it is known that no taxes were "evaded" by anyone as the result of the formation or existence of the petitioner?

II.

If the petitioner had in fact earned or received income from the purchase and re-sale of Coca-Cola syrup (which for the years prior to 1941 it is known that it did not), would such income have been personal holding company income, as defined in Section 502 of the Internal Revenue Code?

SUMMARY STATEMENT OF THE FACTS.

Hugh Smith, an individual, owned and operated Coca-Cola bottling plants at Union City, Tennessee, and at four other near-by towns. He purchased all his Coca-Cola syrup from Coca-Cola Bottling Works (Thomas), Inc., of Chattanooga, Tennessee.

In the summer of 1931 Mr. Smith was advised that the legal department of the Coca-Cola Company considered the contract under which he was buying his syrup and operating each of his bottling plants as "individual" to him; and that, since it was not made to any "heirs or assigns," it would come to an end at his death. And it was suggested to Mr. Smith, by a representative of Thomas, Inc., that "in order to perpetuate the contract he form a corporation"—which he did (R. 77). He then surrendered his individual contract to Thomas, Inc., who re-issued it to the new corporation, Hugh Smith, Inc., the petitioner here; and the corporation issued its sub-bottler's contract to Mr. Smith—who continued on in the operation of his bottling companies, just as he had before the formation of the petitioner corporation. And he, individually, bought all the Coca-Cola syrup he used from Thomas, Inc., and at exactly the same price he had been paying before the formation of the corporation. And the syrup was all shipped to him, and billed to him, and paid for by him; all in exactly the same manner as before the corporation was formed (R. 78).

The petitioner, Hugh Smith, Inc., never bought or sold a single gallon of Coca-Cola syrup, or anything during the lifetime of Hugh Smith, the individual (R. 78, 88). It had no operations. There was never any intention that it would operate (R. 59). The sole object in forming the corporation was to "hold the franchise" so that it might be perpetuated indefinitely and afford Mr. Smith the power to give his heirs and beneficiaries the benefit of it (R. 59).

For the years 1931 to 1940, inclusive, the petitioner had no earnings. It paid, and could have paid, no dividends. It had no undistributed surplus. It simply did not operate; but served only to hold the contract with the Coca-Cola Company.

But for each of the years 1934 to 1937, inclusive, the Commissioner "allocated" to the petitioner a net income equal to 20 cents on each gallon of Coca-Cola syrup *purchased and used by Mr. Smith.* That is the amount of gross profit it could have earned if it had operated under its contracts by which it could have purchased syrup from Thomas, Inc., at $1.30 a gallon and could have sold it to Mr. Smith for $1.50 a gallon. That, of course, would have reduced Mr. Smith's taxable income by 20 cents a gallon. Instead of doing this, Mr. Smith simply purchased the syrup from Thomas, Inc.—for $1.30 a gallon.

After "allocating" this mythical, non-existent, income to the petitioner (under his asserted authority in Section 45 of the Internal Revenue Code), the Commissioner held that such income (if it had been earned) would have been personal holding company income, and that, since all of petitioner's stock was owned by only five individuals, such income was subject to the surtax on personal holding companies, provided by Section 500 of the Code.

The Commissioner did not reduce Mr. Smith's individual income by the amount he "allocated" to the petitioner—or by any amount. Although he stated in his notice of deficiency that he had allowed such deductions to "Hugh C. Smith prior to his death, and his estate thereafter" (R. 10), it was proved that it was not allowed and that this "is not a true statement" (R. 98). He did not assert or contend that any taxes had been evaded by Mr. Smith, or by anyone, as a result of the organization or existence of the petitioner.

After Mr. Smith's death (which occurred on August 25, 1940) and beginning with January 1, 1941, there *was* credited to the petitioner 20 cents on each gallon of Coca-Cola syrup used by the bottling plants—then owned by his estate. This income was reported by the petitioner for the year 1941 and for 1942, up to the date of its dissolution, on May 31, 1942; and it paid corporation income tax and excess profits tax on such income. However, the Commissioner held that such income so reported was subject to *personal holding company surtax*—and he assessed same, together with interest.

The net results of all this are summarized in the statements below:

Totals of Income, and of Tax and Interest Paid Thereon, from 1937 to 1940—the Period Before Mr. Smith's Death.

1937 to 1940

Income "Allocated" to Hugh Smith, Inc. (R. 35)	$ 58,679.64
Tax Paid by the Former Stockholders of Hugh Smith, Inc., on This $58,679.64 of "Income" (R. 52)	$ 60,877.51
Add: Interest Assessed (and Paid) on This Tax	$ 28,895.85
Total Tax and Interest Paid by the Former Stockholders on This $58,679.64 of "Income," Never Received	$ 89,773.36
Add: Amount of Tax Already Paid by Hugh Smith, the Individual, on This Same Income	$ 24,919.89
Total Tax and Interest Paid on This $58,679.64 of Income	$114,693.25

Totals of Income, and of Tax and Interest Paid Thereon, from 1941 and 1942—the Period After Mr. Smith's Death.

1941 and 1942

Amount of Income Earned, Received and Reported (not "Allocated") by Hugh Smith, Inc., for 1941 and 1942, at 20¢ per Gal. (R. 35)	$ 26,906.47
Income and Excess-profits Tax Paid by Hugh Smith, Inc., on Its Returns As Filed (R. 22, 23)	$ 10,547.34
Add: Personal Holding Co. Tax, Additional Income Tax, etc., Assessed Against Hugh Smith, Inc. (and Paid by Its Former Stockholders) (R. 22, 23)	$ 23,361.60
Total Tax Assessed (and Paid) on This $26,-906.47	$ 33,908.84
Add: Interest Assessed (and Paid) on This Additional Tax	$ 7,839.21
Total Tax and Interest Paid on This $26,906.47	$ 41,748.15

Totals of Income, and of Tax and Interest Paid Thereon, from 1937 to 1942.

1937 to 1942

Income "Allocated" to Hugh Smith, Inc. (R. 35)	$ 85,586.11
Tax Paid by the Former Stockholders of Hugh Smith, Inc., on This $85,586.11 of "Income" Never Received (R. 52)	$ 84,239.11
Add: Interest Assessed (and Paid) on This Tax	$ 36,735.06
Total Tax and Interest Paid on This $85,586.11 of "Income" (R. 35) Never Received	$120,974.17

Add: Amount of Tax Already Paid by Petitioner on $26,906.47 of This Same Income for 1941-1942	$ 10,547.34
Amount of Tax Already Paid by Hugh Smith, the Individual, on $58,679.64 of This Same Income for 1937 to 1940	$ 24,919.89
Total Tax and Interest Paid on This $85,586.11 of "Income" So "Allocated"	$156,441.40

REASONS FOR GRANTING THE PETITION.

I.

The United States Court of Appeals for the Sixth Circuit has, decided (or has, by entering its order, without opinion, refused to decide) two important questions of Federal income tax law, which have not been but should be settled by the Supreme Court.

Section 45 of the Internal Revenue Code is an important statute in the law of Federal income taxation. It gives the Commissioner wide discretion to "allocate" income; *but* only when such "allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income."

Does it give him authority to "allocate" when there *has been no evasion?* or when the *income is clearly reflected;* and when it has been reported, and tax has been paid on all of it?

Does it give him authority to "allocate" income (as he has done in this case) for the sole purpose of collecting more tax? Does it give him authority to collect $119,706.34 in tax on $85,586.11 of income? And $36,735.06 in interest on the tax asserted and assessed on non-existent income? That was not the purpose of Section 45.

The *Report of the Committee on Finance* (Sen. Rept. No. 960, 70th Cong., 1st Sess., p. 24) and the *Report of the Committee on Ways and Means* (H. R. Rept. No. 2, 70th Cong., 1st Sess., p. 16) which accompanied the Revenue Bill of 1928 contained the following statement:

> "Section 45 is based upon Section 240(f) of the 1926 Act, broadened considerably *in order to afford adequate protection to the Government*. The section of the new bill provides that the Commissioner may, in the case of two or more trades or businesses owned or controlled by the same interests, apportion, allocate, or distribute the income or deductions between or among them *in such manner as may be necessary in order to prevent evasion* (*by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'*) *and* in order to arrive at their true tax liability.
>
> "*The purpose* of the provisions of Section 45 is to *prevent the arbitrary shifting of gross income* and deductions among businesses owned or controlled by the same interests; to prevent the avoidance of taxes or the distortion of income by the shifting of profits from one business to another; to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income of the property and business of a controlled taxpayer. The statute vests in the Commissioner the discretionary power to make allocations of gross income and deductions of such businesses *when warranted* in order (1) to 'prevent evasion of taxes' or (2) 'purely to reflect the income' of any such businesses" (Emphasis supplied).

In the instant case there was no "evasion of taxes," neither by Mr. Smith, by the petitioner, nor by any stockholder of the petitioner. If the petitioner corporation had *never been formed,* Mr. Smith's taxes (and the taxes of the other stockholders, as well) would have been exactly in the amounts paid. There were no "fictitious sales," no "shifting of gross income," no "milking" of the petitioner corporation—or of any taxpayer.

II.

The United States Court of Appeals for the Sixth Circuit has, likewise, decided (or has, by entering its order without opinion, refused to decide) another, second, important question of Federal income tax law, which has not been but should be settled by the Supreme Court, that is as to whether the purchase of Coca-Cola syrup at $1.30 a gallon and its re-sale at $1.50 a gallon (which was done in 1941 and 1942—but not prior to 1941) resulted in a gain which can properly be held to be comprised in the definition of "personal holding company income" in Section 502 of the Internal Revenue Code.

III.

The Commissioner "allocated" to the petitioner a part of the income of Mr. Smith (for which he allowed Mr. Smith no off-setting deduction—R. 98), which the petitioner never earned or received (but which Mr. Smith did receive, and on which he paid all the income tax due thereon), under a claim of authority in Section 45, but which is not given him by such section. He *then claimed,* further, that this wholly fictitious income was personal holding company income, and that, since no personal holding company returns had been filed he was authorized to assess the personal holding company surtax, and penalty, on it, back

to the year 1934, in which year the personal holding company surtax was first imposed. And this, despite the fact that the Commissioner and his revenue agents had "all the facts before" them, from an examination of the petitioner's corporation income tax return for the year 1934, and from the returns filed year by year for each of the subsequent years to and including 1942; and despite the fact that the respondent having knowledge of the factual circumstances surrounding the petitioner's business through his agent's report for 1934, did not deem it necessary, for petitioner to file personal holding company returns." *Hugh Smith, Inc.*, 8 T. C. 660, 677.

IV.

The Commissioner has thus claimed authority (which he does not have) under Section 45 to "allocate" income (which did not exist) to the petitioner, for the sole purpose of taxing it as personal holding company income—when he and his agent alike, "having factual knowledge" of the petitioner's business and of the nature of its income, had considered and found it not to be personal holding company income during all the years the petitioner was in existence, 8 T. C. 660, 677.

Thus the order of the Sixth Circuit (affirming the decision of the Tax Court) leaves the law in a state of uncertainty, so much so that no taxpayer can ever be certain that he will not be called on to pay tax on income he never earned, or received, or even ever heard of; and the determination by this Court of this question of the limits, if any, to which the Commissioner may go under the guise of Sections 45 and 502 will settle the point of law, and remove the uncertainty, and make for uniformity of decisions in the future.

Wherefore, it is respectfully submitted that this petition for writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit should be granted.

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April ....., 1949.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statutes and regulations involved	2
Statement	2
Argument	8
Conclusion	18
Appendix	19

CITATIONS

Cases:

Asiatic Petroleum Co. v. *Commissioner*, 79 F. 2d 234, certiorari denied, 296 U. S. 645	15
Commissioner v. *Court Holding Co.*, 324 U. S. 331	9, 13
G. U. R. Co. v. *Commissioner*, 117 F. 2d 187	15
Moline Properties v. *Commissioner*, 319 U. S. 436	8, 12
National Carbide Corp. v. *Commissioner*, 336 U. S. 422	8, 9, 12
National Securities Corp. v. *Commissioner*, 137 F. 2d 600, certiorari denied, 320 U. S. 794	15
United States v. *Joliet & Chicago R. Co.*, 315 U. S. 44	9, 13

Statutes:

Internal Revenue Code:	
Sec. 22 (26 U.S.C. 1946 ed., Sec. 22)	13, 22
Sec. 45 (26 U.S.C. 1946 ed., Sec. 45)	14, 22
Sec. 501 (26 U.S.C. 1946 ed., Sec. 501)	22
Sec. 502 (26 U.S.C. 1946 ed., Sec. 502)	16, 17, 22
Revenue Act of 1928, c. 852, 45 Stat. 791, Sec. 45	14
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 22	13, 19
Sec. 45	14, 19
Sec. 351	16, 20
Sec. 353	16, 17
Revenue Act of 1937, c. 815, 50 Stat. 813, Sec. 1	20
Revenue Act of 1938, c. 289, 52 Stat. 447:	
Sec. 22	13, 22
Sec. 45	14, 22
Sec. 402	22
Sec. 403	16, 17, 22

Page

Miscellaneous:

H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17 (1939-1 Cum. Bull. (Part 2) 384, 395) 14
H. Rep. No. 704, 73d Cong., 2d Sess., p. 24 (1939-1 Cum. Bull. (Part 2) 554, 572) 14
S. Rep. No. 558, 73d Cong., 2d Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 586, 608) 14
S. Rep. No. 960, 70th Cong., 1st Sess., pp. 24-25 (1939-1 Cum. Bull. (Part 2) 409, 426) 14

Treasury Regulations 94:
Art. 22(a)-1 22
Art. 45-1 ..... 14, 23
Art. 351-2 ..... 16, 26

Treasury Regulations 101:
Art. 22(a)-1 26
Art. 45-1 ..... 14, 26
Art. 403-1 ..... 16, 26

Treasury Regulations 103:
Sec. 19.22(a)-1 26
Sec. 19.45-1 ..... 14, 26
Sec. 19.502-1 ..... 16, 26

Treasury Regulations 111:
Sec. 29.22(a)-1 26
Sec. 29.45-1 26
Sec. 29.502-1 26

In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 731

HUGH SMITH, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 25-49) is reported at 8 T. C. 660. The affirming order of the Court of Appeals (R. 159) is reported at 173 F. 2d 224.

JURISDICTION

The judgment of the Court of Appeals was entered February 1, 1949. (R. 159.) The petition for a writ of certiorari was filed April 16, 1949. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

1. Taxpayer corporation, owner of an exclusive territorial franchise covering the trademark Coca-Cola, licensed the use of the trademark to its controlling stockholder, Smith, in consideration of stipulated royalties. Smith used the trademark in his individually owned bottling business, but caused taxpayer to collect and report only a portion of the royalties he contracted to pay. The Commissioner, exercising the authority vested in him by Section 45 of the applicable Revenue Acts and Internal Revenue Code, added the uncollected portion of the royalties to taxpayer's gross income as defined in Section 22 (a), and deducted it from Smith's business income. Did the courts below err in sustaining the Commissioner's determination?

2. Was taxpayer a personal holding company as defined in Section 351 (b) of the Revenue Act of 1936 and corresponding provisions of the Revenue Act of 1938 and the Internal Revenue Code?

STATUTES AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 19-26.

STATEMENT

The facts as found by the Tax Court (R. 27-35) may be summarized as follows:

In 1931 Hugh Smith owned and operated five Coca-Cola bottling plants in Tennessee and Kentucky under a contract with Coca-Cola Bottling Works (Thomas) Inc. (hereafter called

"Thomas"). Thomas, known as a "parent bottler" under the Coca-Cola Company, had an exclusive license relative to the bottling and selling of Coca-Cola in certain states including Tennessee and Kentucky, and was permitted to assign its rights to others. The Coca-Cola Company advised Smith that his rights under the contract with Thomas were personal, ending with his death, and suggested that he surrender his contract and form a corporation to which the rights could be reissued. Accordingly, in July of 1931 Smith caused the taxpayer corporation to be formed for the purpose of acquiring a perpetual license from Thomas. (R. 27-28.) The corporation issued sixty shares of stock which were paid for by Smith; and throughout the taxable year Smith (and after his death, his estate) held a majority of stock, the remainder being held by his wife and employees. (R. 27, 30.)

In September of 1931 Thomas and taxpayer entered into a "Bottlers Contract (First Line)", whereby Thomas transferred "the sole and exclusive right and license that it received by approved transfer from Coca-Cola Company to use and vend on bottled Coca-Cola the trademark name Coca-Cola, and all labels and designs pertaining thereto, in connection with the product 'Bottled Coca-Cola'" within a specified territory in Tennessee and Kentucky. Thomas also agreed to "obtain and furnish" to taxpayer "sufficient syrup for bottling purposes to meet the requirements" of taxpayer in the territory provided Thomas could obtain de-

livery of the syrup under its contract with the Coca-Cola Company. In consideration taxpayer agreed to "buy of or through" Thomas all the Coca-Cola syrup "required or used" by it and to pay $1.30 per gallon of syrup "delivered to any point in the above described territory". The consent of the Coca-Cola Company was endorsed on the contract. (R. 28-29; Ex. 6, R. 106-108.) On the same day taxpayer entered into a "Sub-bottler's Contract" with Smith, whereby taxpayer transferred to Smith "the sole and exclusive right and license that it received" from Thomas, and Smith agreed to pay to taxpayer $1.50 per gallon of syrup delivered to any point in the described territory. Thomas and Coca-Cola Company endorsed their consent to this contract, and the original contract between Thomas and Smith was canceled. (R. 29-30; Ex. 7, R. 109-111.)

All syrup coming into the territory controlled by Thomas was shipped by Coca-Cola Company from one of its manufacturing plants directly to the sub-bottlers who actually bottled the product and who, for purposes of saving time and expense, were authorized to place their orders for syrup directly with the Coca-Cola Company. The orders so placed were considered as given through Thomas, the parent bottler, and all payments for syrup were made to Thomas. Whether Thomas was paid by the first-line bottler (taxpayer) or the sub-bottler (Smith) depended upon the arrangements between the latter, and Thomas did not in-

sist upon payment from the first-line bottler. (R. 30-31.) After the execution of the sub-bottler's contract between Thomas and Smith the latter continued as before to order syrup used in his plants directly from the Coca-Cola Company and to make payment to Thomas of $1.30 per gallon. Smith never ordered syrup from taxpayer, and taxpayer never directly placed an order with Thomas or Coca-Cola Company nor directly paid either of them for any syrup shipped to Smith's plants. (R. 31.)

Smith managed and controlled both his bottling plants and taxpayer corporation until his death on August 25, 1940. After his death and until the dissolution of taxpayer on May 30, 1942, the bottling plants and taxpayer were controlled by his executor and trustee. (R. 30.) Taxpayer's assets at the time of Smith's death consisted of petty cash, two autos, and the Coca-Cola franchise. Its assets were substantially the same upon its dissolution, and they were distributed pro rata to the stockholders, who assumed its liabilities. The value of taxpayer's stock at the date of Smith's death was fixed for estate tax purposes at $10,491 per share, or over $600,000 for its sixty shares outstanding. Taxpayer never declared a dividend nor made a distribution purporting to be such. (R. 31).

Taxpayer had no office or employees of its own and was not listed in any telephone directory. Its books were kept by an employee of Smith, under his direction. (R. 30.) However, it maintained a

bank account from the time it was organized in 1931. Its disbursements included salaries to Smith and his wife, payments on new automobiles, repairs, license fees, insurance premiums on automobiles, capital stock taxes; and city, county, and state taxes. (R. 32-33.)

In its income tax returns for 1931 to 1941 inclusive, and for the period January 1, to May 31, 1942, taxpayer reported "royalty" income received from Smith and, after his death, from his executor. No other income was reported. In its 1932 and 1933 returns it stated that its main business was "Collecting Syrup Royalties on Contracts"; in its returns for 1932 through 1939 it stated it was engaged in the "Commission" business; and in its 1938 and 1939 returns it stated its business classification to be "Royalties". (R. 32.) The amounts reported as royalty income corresponded with deposits reflected in taxpayer's bank pass books (R. 33.)

For 1934 through 1940 the royalty income reported by taxpayer was less than 20¢ per gallon on the Coca-Cola syrup used by Smith's plants in those years; for 1941 it was slightly more, and for the period January 1 to May 31, 1942, it was exactly equal. (R. 32, 33, 38-39.) Exercising the authority vested in him by Section 45 of the applicable Revenue Acts and the Internal Revenue Code, the Commissioner increased taxpayer's royalty income for 1937 through 1940 and decreased its reported royalty income for 1941, so that the taxable income

each year equaled 20¢ per gallon on all the syrup used by Smith's plants in those years; the amounts by which taxpayer's income was increased were allowed by the Commissioner as additional deductions in computing the business income of Smith. (R. 10, 13, 34, 40.) Income tax deficiencies were asserted only for the years 1937 through 1940, prior years being barred by the statute of limitations. (R. 16.)[1] The Tax Court, in a decision reviewed by the full court, unanimously held that the Commissioner's allocation was proper, and sustained his determination. (R. 35-41.)

Taxpayer failed to file any personal holding company returns. (R. 47.) The Commissioner determined that it was a personal holding company as defined in the applicable Revenue Acts and computed personal holding company surtax deficiencies for the year 1934 through 1941, and for the period January 1 to May 31, 1942, together with a 25% penalty for failure to file a return. In computing taxpayer's personal holding company income subject to surtax, the Commissioner did not allow any dividends paid credit. (R. 9-10.) The Tax Court sustained the Commissioner's determination that taxpayer was a personal holding company, and his disallowance of a dividends paid

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[1] The excess profits tax deficiencies for 1937 through 1939, and the declared value excess profits tax deficiency for 1940, result from the adjustments of taxpayer's net income. (R. 17-21.) The Commissioner made various other adjustments in taxpayer's income for the taxable years here involved, the correctness of which was conceded below. (R. 13-15, 36.)

credit for 1936 and subsequent years. It overruled the Commissioner's disallowance of a dividends paid credit for the years 1934 and 1935, holding that for those years taxpayer was not subject to any personal holding company surtax. (R. 41-47.) The Tax Court also overruled the Commissioner's determination that taxpayer was subject to penalty for failure to file personal holding company returns. (R. 47-49.) One judge dissented from that part of the Tax Court's decision which held that taxpayer was not subject to penalty. (R. 50-51.)

Taxpayer appealed from those portions of the Tax Court's decision which were adverse to it. The Commissioner did not cross-appeal. The Court of Appeals affirmed upon the grounds and for the reasons set forth in the Tax Court's opinion. (R. 159.)

ARGUMENT

There is no occasion for further review. The decision below is correct, and does not present a conflict.

1. Taxpayer does not and cannot assert conflict. It charges error in the decision below, on the theory (Pet. 2, 9) that it never "earned or received" the income in question. The charge rests upon a two-fold misconception of basic principles. Taxpayer assumes, contrary to the decisions of this Court (*Moline Properties* v. *Commissioner*, 319 U. S. 436; *National Carbide Corp.* v. *Commissioner*, 336 U. S. 422), that a corporation and its con-

trolling stockholder are not separate taxable entities; accordingly, it views this case as if it "had *never been formed*" (Pet. 9).[2] Taxpayer further assumes, contrary to the decisions of this Court (*United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *National Carbide Corp.* v. *Commissioner, supra*), that a corporation is not taxable on earned income unless it actually receives the income; accordingly, it treats the uncollected portion of its income as "non-existent" and "fictitious" (Pet. 4, 9). Stripped to essentials, taxpayer's argument reduces itself to the patently untenable proposition that a controlling stockholder who uses the property of his corporation (in this case a valuable franchise) in his individually owned business and contracts to pay for such use can, by preventing the corporation from collecting the full consideration due from him, relieve it *pro tanto* of tax liability.

2. The critical facts supporting the decision below are ignored in the petition. Throughout the taxable years Smith (and after his death, his estate) was the controlling stockholder of taxpayer and operated several bottling plants. (R. 27, 30,

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[2] Taxpayer's tables (Pet. 5-7) purporting to show its total tax plus interest resulting from the Commissioner's deficiency determination combine a separate tax liability of its stockholders with its own income, excess profits, and personal holding company surtax liability.

36, 42.)[3] Shortly after its organization taxpayer (as "first line" bottler) acquired from Thomas, Inc., a "parent bottler" under the Coca-Cola Company (R. 27), "the sole and exclusive right and license * * * to use and vend on bottled Coca-Cola the trademark name Coca-Cola, and all labels and designs pertaining thereto" within a designated territory, in consideration of royalty payments to Thomas measured by $1.30 per gallon of Coca-Cola syrup delivered to any point in the licensed territory (R. 28-29; Ex. 6, R. 106-108). With the consent of Thomas and the Coca-Cola Company, taxpayer conveyed to Smith a "Sub-bottler's" license covering the same territory, in consideration of royalty payments by Smith to taxpayer measured by $1.50 per gallon of syrup delivered to any point in the territory. (R. 29-30; Ex. 7, R. 109-111.) Thomas had no facilities for shipping syrup into the territory controlled by it as the parent licensor. All syrup coming into the territory was shipped by Coca-Cola Company directly to the sub-licensees who actually bottled the product and who, for the purpose of saving time and expense, placed their orders for syrup directly with Coca-Cola Company; the orders so given were considered as given through Thomas. (R. 30-31.)

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[3] Smith died on August 25, 1940. From the time of his death to the dissolution of taxpayer on May 30, 1942, his stock was held by his estate, which carried on his bottling business. (R. 30.) Unless otherwise noted references herein to Smith apply to his estate with respect to taxable periods after his death.

After acquiring the sub-license from taxpayer, Smith continued as before to order syrup used in his bottling plants directly from the Coca-Cola Company. (R. 31.) Whether the royalty due Thomas as parent licensor was paid by the first-line licensee (taxpayer) or by the sub-licensee (Smith) depended on the arrangements between the latter two; it was immaterial to Thomas from whom it received payment. (R. 30-31, 37.) As controlling stockholder of taxpayer, Smith determined the method of payment, and he paid directly to Thomas the royalty of $1.30 per gallon which taxpayer contracted to pay to Thomas. (R. 31, 37-38.) As for the over-riding royalty of 20¢ per gallon which Smith contracted to pay to taxpayer, however, taxpayer reported royalty income in amounts which did not correspond to the amounts called for by the contract. For 1934 through 1940 taxpayer reported less than the amount due to it; for 1941 (after Smith's death) it reported slightly more; and for the period January 1 to May 30, 1942 (the date of taxpayer's dissolution), the amount reported was exactly equal to the royalties due to it. (R. 32-33, 38-39.)

Exercising the authority lodged in him by Section 45 of the applicable Revenue Acts (Appendix, *infra*), the Commissioner increased taxpayer's royalty income for 1937 through 1940[4] and de-

[4] No income tax deficiencies were asserted for years prior to 1937 because assessment for such years was barred by the statute of limitations. (R. 16.)

creased it for 1941, so that the royalty income for each year equaled 20¢ per gallon on all the syrup delivered to Smith's plants in those years; and in computing the business income of Smith the Commissioner allowed as additional deductions for the respective years amounts corresponding to those added to taxpayer's income. (R. 10, 13, 34, 40.)

The decision below, sustaining the Commissioner's determination, is correct on either of two alternative grounds: (a) the portion of the royalties which Smith contracted but failed to pay to taxpayer is includible in taxpayer's gross income as defined in Section 22 (a) of the applicable Revenue Acts (Appendix, *infra*); (b) the Commissioner did not abuse the authority vested in him by Section 45 in adding the unpaid portion to taxpayer's royalty income and subtracting a like amount from Smith's business income.

(a) Taxpayer corporation unquestionably was a separate taxable entity, distinct from its controlling stockholder Smith. *Moline Properties* v. *Commissioner,* 319 U. S. 436; *National Carbide Corp.* v. *Commissioner,* 336 U. S. 422.[5] It is axiomatic that the reach of Section 22 (a), which broadly defines "gross income", is not to be circumscribed

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[5] Taxpayer was organized for the business purpose of acquiring a territorial license covering the Coca-Cola trademark which would not terminate with Smith's death. (R. 28.) It filed income tax returns for every year until its dissolution (R. 27), in which it represented its "business" to be that of

by arrangements which prevent passage of the income into the taxpayer's hands. The rule applies with no less force to corporate than to individual taxpayers. *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Commissioner* v. *Court Holding Co.*, 324 U. S. 331. By failing to remit to his controlled corporation the full amount of royalties which he contracted to pay for the use of its property—the Coca-Cola franchise—Smith retained income which belonged to the corporation. That the corporation did not receive the income does not, as it assumes, relieve it of tax liability. Had it conveyed the property to an independent licensee, payment of the royalties directly to its stockholders manifestly would not have insulated it from tax; the stockholders' right to the income would be "strictly derivative". *United States* v. *Joliet & Chicago R. Co., supra*, p. 48. Where as here the corporation transfers its property to a controlling stockholder, who uses the property in his own business but retains part of the consideration due from him to the corporation, the situation is essentially the same and the tax result can be no different. Since the income in question is taxable to taxpayer under Section 22 (a) and established principles governing the application of that sec-

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collecting "royalties". (R. 32, 35-36.) The value of its stock was over $10,000 per share, or more than $600,000 for its sixty outstanding shares, practically all of which value was attributable to its Coca-Cola franchise. (R. 31, 75.)

tion, there was no need for the Commissioner here to resort to the special allocation powers residing in him under Section 45.

(b) In any event, the courts below were fully justified in sustaining the Commissioner's determination under Section 45. That section empowers the Commissioner to "allocate gross income or deductions" between commonly "controlled" businesses "if he determines" that such allocation is necessary to prevent tax evasion "or clearly to reflect the income" of any such business. The legislative history of the section and the long-standing implementing Treasury Regulations (Appendix, *infra*),[6] to say nothing of the section itself, reveal a Congressional intent to place in the Commissioner broad discretionary authority to prevent a distortion of taxable income between commonly controlled taxpayers. Acting under that section the Commissioner increased taxpayer's gross income by the amount of royalties which its controlling stockholder Smith contracted but failed to pay to

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[6] Section 45 first appeared in its present form in the Revenue Act of 1928, c. 852, 45 Stat. 791. See H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17 (1939-1 Cum. Bull. (Part 2) 384, 395); S. Rep. No. 960, 70th Cong., 1st Sess., pp. 24-25 (1939-1 Cum. Bull. (Part 2) 409, 426); H. Rep. No. 704, 73d Cong., 2d Sess., p. 24 (1939-1 Cum. Bull. (Part 2) 554, 572); S. Rep. No. 558, 73d Cong., 2d Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 586, 608). The section was designed to achieve equality of tax treatment among controlled and uncontrolled taxpayers, and applies whether the distortion of net income is intended or inadvertent. See Article 45-1 of Regulations 94 under the 1936 Act (Appendix, *infra*), which is the same as the corresponding provisions of Regulations 101 under the 1938 Act and Regulations 103 under the Internal Revenue Code.

it, and correspondingly reduced Smith's business income for the reason (R. 10, 13) that such action was "necessary in order to clearly reflect" the respective business incomes of taxpayer and Smith. Unless the Commissioner's determination constituted a clear abuse of the authority delegated to him by Section 45, his action may not be disturbed. *Asiatic Petroleum Co.* v. *Commissioner,* 79 F. 2d 234 (C. A. 2d), certiorari denied, 296 U. S. 645; *National Securities Corp.* v. *Commissioner,* 137 F. 2d 600 (C.A. 3d), certiorari denied, 320 U. S. 794; *G. U. R. Co.* v. *Commissioner,* 117 F. 2d 187 (C.A. 7th). His determination was "neither arbitrary nor capricious" (*National Securities Corp.* v. *Commissioner, supra,* p. 602), but was amply warranted by the uncontroverted facts. The Tax Court found, and it is undisputed, that taxpayer was "controlled" within the meaning of Section 45 by Smith, as were also Smith's individually owned bottling companies (R. 27, 30, 36); that taxpayer acquired an exclusive territorial franchise covering the Coca-Cola trademark rights in consideration of specified royalty payments to its licensor (R. 28-29); that taxpayer granted a sub-license to Smith in consideration of an overriding royalty profit measured by 20¢ per gallon on all Coca-Cola syrup delivered to the licensed territory (R. 29-30); that Smith received the full benefit of his contract with taxpayer by using the trademark in his own business (R. 31); and that (except for the period subsequent to Smith's

death) only a part of the consideration payable by Smith under that contract was paid to taxpayer and reported by it for tax purposes (R. 32, 38-39). To the extent that Smith failed to pay the entire consideration due from him, taxpayer's business income was understated and Smith's business income was overstated. Clearly the Commissioner had power under Section 45 to prevent such a transparent distortion of income between two commonly controlled businesses.

3. Taxpayer's contention (Pet. 2, 9-10) that the courts below erred in deciding that it was a personal holding company is equally without merit. This contention rests upon taxpayer's supposition that its income did not represent "royalties" as that term is used in the applicable Revenue Acts (Appendix, *infra*),[7] but profits from the purchase and resale of syrup. The pertinent Treasury Regulations[8] define "royalties" as including amounts received "for the use of * * * trade marks, trade brands, franchises, and other like property". Quite apart from the fact that in its returns taxpayer itself classified the income as "royalties" (R. 32), it is plain from its licensing contract with Thomas (R. 106-108) and its sub-

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[7] Section 351 (b) (1) of the 1936 Act; Section 353 (a) of the 1936 Act as amended by the 1937 Act; Section 403 (a) of the 1938 Act; Section 502 (a) of the Internal Revenue Code.

[8] Article 351-2 of Regulations 94 under the 1936 Act; Article 403-1 of Regulations 101 under the 1938 Act; Section 19.502-1 of Regulations 103 under the Internal Revenue Code.

licensing contract with Smith (R. 109-111) that the amounts payable to it by Smith fall in that category.[9] That the amounts were measured by the quantity of syrup shipped into the licensed territory does not render them any the less royalties. Thomas (the "parent bottler") never delivered any syrup to taxpayer (the "first-line bottler"), nor did taxpayer deliver any to Smith (the "sub-bottler"); the syrup was shipped directly by Coca-Cola Company to the sub-bottlers who actually bottled the product. (R. 30-31.) Taxpayer occupied the same position vis-a-vis Smith as did Thomas with respect to taxpayer. Its business, like that of Thomas, consisted of acquiring and licensing the use of the Coca-Cola trademark on bottled Coca-Cola, not that of bottling the product. The more than $600,000 value of taxpayer's sixty shares of stock (R. 31, 75) represented its valuable right to use and sell the trademark, not a right to buy and sell syrup.

Even assuming that the income in question did not constitute "royalties", it must nevertheless be classified as personal holding company income under Section 353 (f) of the 1936 Act as amended by the 1937 Act (Appendix, *infra*) and corresponding provisions of the later Revenue Acts.[10]

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[9] Taxpayer acquired from Thomas, and in turn transferred to Smith "the sole and exclusive right and license * * * to use and vend on bottled Coca-Cola the trademark name Coca-Cola, and all labels and designs pertaining thereto, in connection with the product 'Bottled Coca-Cola' ". (R. 106, 109.)

[10] Section 403 (f) of the 1938 Act; Section 502 (f) of the Internal Revenue Code.

This section added to the categories of personal holding company income "compensation" for the "use" of a corporation's "property" by a stockholder owning 25% or more of its outstanding stock. The franchise which taxpayer acquired from Thomas and in turn transferred to Smith was property; the 20¢ per gallon differential which Smith contracted to pay to taxpayer represented compensation for the use of that property; and over 25% of taxpayer's stock was owned by Smith.

CONCLUSION

This case turns on its own facts, and the decision below is correct. There is no conflict. The petition should be denied.

Respectfully submitted,

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MAY, 1949.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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SEC. 45. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

* * * * *

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) *Imposition of Tax.*—There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

* * * * *

(b) *Definitions.*—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank, as defined in section 104, and other than a life-insurance company or surety company) if —(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. * * *

* * * * *

Revenue Act of 1937, c. 815, 50 Stat. 813:

SEC. 1. AMENDMENT OF 1936 ACT.

Title IA of the Revenue Act of 1936 is amended to read as follows:

* * * * *

"SEC. 352. DEFINITION OF PERSONAL HOLDING COMPANY.

"(a) *General Rule.*—For the purposes of this title and of Title I the term 'personal holding company' means any corporation if—

"(1) *Gross income requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 353; * * *

"(2) *Stock ownership requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

* * * * *

"SEC. 353. PERSONAL HOLDING COMPANY INCOME.

"For the purposes of this title the term 'personal holding company income' means the portion of the gross income which consists of:

"(a) Dividends, interest, royalties (other than mineral, oil, or gas royalties), annuities.

* * * * *

"(f) *Use of Corporation Property by Shareholder.*—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at

any time during the taxable year, 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement."

* * * * *

Sections 22 (a) and 45 of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code are substantially the same as the same numbered sections of the Revenue Act of 1936. Sections 402 (a) and 403 (a) and (f) of the Revenue Act of 1938, and Sections 501 (a) and 502 (a) and (f) of the Internal Revenue Code, are substantially the same as Sections 352 (a) and 353 (a) and (f) of the Revenue Act of 1936 as amended by the Revenue Act of 1937.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 22 (a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * * *

Art. 45-1. ***Determination of the taxable net income of a controlled taxpayer.*****—(a)** ***Definitions.*****—**When used in this article—

(1) The term *"organization"* includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Act or these regulations), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms *"trade"* or *"business"* include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term *"controlled"* includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form nor the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term *"controlled taxpayer"* means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) *"Group"* or *"group of controlled taxpayers"* means the organizations, trades, or

businesses owned or controlled by the same interests.

(6) The term *"true net income"* means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deduction, or the item or element of either, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, choose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(*b*) *Scope and purpose.*—The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable

net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

(*c*) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

Art. 351-2. *Classification of a personal holding company.*—

* * * * *

From the standpoint of the nature of the gross income, a corporation comes within the definition of a personal holding company for any taxable year when 80 percent or more of its gross income for such taxable year was derived from the following sources:

(1) *Royalties.*—The term "royalties" includes amounts received for the use of or for the privilege of using patents, copyrights, secret processes and formulas, good will, trade marks, trade brands, franchises, and other like property. * * *

* * * * *

The provisions of Articles 22 (a)-1, 45-1, and 403-1 of Regulations 101, under the 1938 Act; of Sections 19.22 (a)-1, 19.45-1, and 19.502-1 of Regulations 103, under the Code, and of Sections 29.22 (a)-1, 29.45-1, and 29.502-1 of Regulations 111, under the Code, are substantially the same.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1943 037192 930